Current Developments in California Law Affecting
Partnerships and Limited Liability Companies - 2002

The 2002 legislative session resulted in passage of several significant statutes affecting partnerships and limited liability companies, the highlights of which are outlined below. Most significant is the passage of a new section of the Corporations Code regarding conversion from one type of entity to another, streamlining the process enormously.

Several interesting court decisions relating to partnerships are also summarized below, including one regarding liability of individual law firm partners to the firm's landlord following dissolution of the firm. Given the recent spate of law firm closures, the topic is one that many California practitioners may have cause to address in the coming year.

Following is a summary of some of the highlights of 2002 in developments relating to the laws applicable to partnerships and limited liability companies.

STATUTES

SB 399 (Ackerman) - Chapter 480 of 2002 Statutes.

This very important bill sets up a major change in California law, to allow conversion of California corporations to other types of entities, and vice versa. The new law provides statutory authority and procedures for conversion by a California corporation into domestic general partnerships, limited partnerships or limited liability companies. It also permits conversion by such entities, whether domestic or foreign, or by a foreign corporation, into a California corporation.

This is accomplished primarily in addition of the new Chapter 11.5 on Conversions, added to the Corporations Code at Sections 1150-1160, which covers:

- Procedures necessary to affect plans of conversion;
- Required filings and fees payable to the Secretary of State's office;
- Presumptions concerning real property previously owned by a converting entity;
- Procedures permitting recording of documents with county recorders concerning the conversion to evidence changes in ownership to the converted entity of such property;
- Required notices to creditors; and
- Liability of shareholders and partners.

Some interesting provisions include the requirement that notice of the conversion be given to creditors of the converting entity within 90 days after the effective date of the conversion. The converted entity will remain liable for the obligations of the converting entity following the switch to the new entity.

A general partner will remain liable for obligations for which such partner is already liable, as well as those incurred within 90 days after the conversion to a corporate entity. However, the general partner of the partnership converting to a corporate form will be able to cut off his or her future liability, gaining the protection of limited personal liability afforded to shareholders of a corporate entity. Under this provision, the general partner's liability for new obligations will stop 90 days after the conversion, whether or not the 90-day notice to creditors is properly or timely given. Corp. Code §§1158 (e), 1158 (f).

An interesting tweak which developed during the passage of the bill (with a great deal of encouragement from the Partnerships and LLCs Committee) is the sunset clause applicable to the $250.00 filing fee payable to the Secretary of State's office. This fee will be reduced to not more than $150.00 as of January 1, 2005. Corp. Code §1160.

The result of this bill is to make available a nifty new toolbox for entities that wish to change their legal structure. The Partnerships and LLCs Committee actively supported and participated in obtaining the passage of this important legislation. This conversion statute lays out a comprehensive statutory scheme that bears a detailed review for those who wish to utilize its provisions.

AB 601 - Leach (Chapter 179 of 2002 Statutes).

This bill is designed to eliminate the distinctions between corporations and other entities, including partnerships and LLCs, that wish to include enforceable covenants against competition in agreements regarding equity or asset sale transactions. It also eliminates the requirement that certain cities and counties be identified in restrictive covenant clauses. The Partnerships and Limited Liability Companies Committee drafted the bill and actively sponsored it through passage during the 2001-2002 legislative session.

Upon a sale of substantially all of the assets of a business, it was previously the case that only those buyers operating in the corporate form could enter into an enforceable covenant against competition with the seller. Those operating in partnerships and limited liability companies were unable to enforce such agreements in an asset sale transaction. This bill permits persons selling the goodwill of a business as part of a sale of assets to enter into an enforceable covenant not to compete with the purchaser.

This was accomplished by amending B&PC Section 16601, expanding the definition of "business entity" to include partnerships and LLCs. Section 16602 permits a partner to enter into such a non compete agreement upon a dissolution of the partnership or dissociation of the partner from the partnership entity. Section 16602.5 authorizes limited liability company members to enter into similar agreements with the limited liability company, enforceable in geographic areas where the company business has been transacted.

Pursuant to these amendments, the language of such covenants restricting competition will no longer be required to specify certain cities or counties to define the geographic scope of the restriction. In defining the area to which the prohibition will apply, it will be sufficient to describe the "specified geographic area" in which the assets were located and the seller's business conducted.

Through these amendments, an unfair and unwarranted distinction between businesses operating in the corporate form, and those operating as partnerships and limited liability companies, was eliminated. Changing the requirements for defining the geographic scope of such clauses to remove the necessity of specifying particular cities and counties will permit parties to address these issues in a more accurate and realistic fashion, the need for which has previously been recognized by the courts.

AB 2355 - Campbell (Chapter 451 of the 2002 Statutes).

This law sets out the authority and procedure which allows a judgment creditor to enforce a judgment against an assignee of an LLC membership interest. This statute was designed to provide a method of levy against a membership interest held by an assignee, rather than by an LLC member, thereby filling a gap in existing law.

Procedurally, this change was accomplished by amending CCP 708.310, CCP 708.320 and Corporations Code Section 17302. Section 17302 sets forth the rights of a judgment creditor to enforce a judgment against a judgment debtor who is the assignee of a membership interest by obtaining a charging order against it. The permitted enforcement actions include appointment of a receiver to collect any distributions to be paid to the judgment debtor, as well as foreclosure of the membership interest, with the purchaser at a foreclosure sale having the rights of an assignee of the interest. Prior to a foreclosure sale, the membership interest may be redeemed by the judgment debtor or any other LLC members, with the consent of all the members.

CCP Section 708.310 adds LLC membership interests to the existing law, which provides for the obtaining of a charging order as a means of enforcing a judgment against a partnership interest. Section 708.320 further provides that a lien is created against a membership interest upon service of the notice of motion to obtain the charging order against all of the members.

These new statutory provisions provide clear authority and a procedural roadmap to enforce a judgment against the assignee of an LLC membership interest. Although this bill was not written by the Partnerships and LLCs Committee, the committee worked with the bill's author to make sure that the proposed amendments remained consistent with other provisions of the Beverly-Killea Limited Liability Companies Act.

CASES

Annod Corporation v. Hamilton & Samuels, 100 Cal.App. 4^{th} 1286, 123 C.R. 2^{nd} 924 (2002).

The plaintiff landlord sued individual partners of a dissolved law firm which operated as a general partnership. Interestingly, the theory of recovery was not based on general partner liability, because the lease agreement included reciprocal waivers of individual liability. Rather, the landlord sought recovery of monies paid to the partners as draws as fraudulent transfers under Civil Code Section 3439, *et. seq.*

The defendant lawyers won summary judgment, based upon their argument that the draws were taken in good faith and for reasonably equivalent value, proof of which provides a complete defense to a Section 3439 claim. Plaintiff landlord appealed, and the judgments in favor of the defendant attorneys were affirmed.

The Court of Appeal agreed with the trial court's finding that defendants had established a complete defense to the fraudulent conveyance claims, having presented evidence sufficient to establish their good faith and reasonably equivalent value.

Included in the evidence presented by the defendants were facts establishing the following: if the draws were not paid, none of the attorneys would have continued working, causing even fewer creditors to be paid; the draws paid were under market value for the services performed; the draws were less than those paid during prior years to the partners; payments received were less than the income credited to each partner's capital accounts in prior years; and the draws represented a fraction of the receivables generated by services performed by their recipients.

The defendants pointed out that at times, their secretaries were making more than the lawyers were (perhaps not an entirely new concept, but one which may have inspired some chuckles from the Court). As further evidence of his good faith, one attorney presented declarations showing that he was paid more than $400,000 by his employment in the year after leaving the firm, from which he had drawn less than $100,000 during the year for which he was being sued as recipient of a fraudulent conveyance by the landlord.

In support of its claim, the landlord argued that the partners were not being paid for current services, but instead, were collecting on past due, unpaid draws. The court noted that payment of one creditor in preference to another is permitted by Civil Code 3432. It is worth noting that different result on this particular issue might occur if the partnership was in bankruptcy, where preferences are recoverable by a trustee pursuant to 11 U.S. C. §547.

The fraudulent transfer theory, while creative, was not successful in holding partners who received partnership draws personally liable. The court specifically noted that no authority was presented to support the argument that accepting partnership compensation while knowing that lease payments are overdue amounts to participation in a fraudulent scheme.

This case bodes well for attorneys who receive draws while their landlords go unpaid. However, the decision will not be of assistance to those who have personal liability under the lease or by partnership status giving rise to such liability, both elements of which were obviated by the reciprocal waivers of personal liability that existed in this case.

Storek & Storek, Inc. v. Citicorp Real Estate, Inc., 100 Cal. App. 4th 44, 122 C.R. 2d 267 (2002).

This is one of two important cases decided last year involving failed real estate limited partnerships. This case addressed the issue of whether the implied covenant of good faith and fair dealing compels application of a good faith standard to a lender's conduct in its refusal to continue provide funding under a loan agreement, which contract permitted the lender to declare a default based on its determination that the project budget was not in balance. The court held that the lender need only make an objectively reasonable determination that the project budget was not in balance, of which fact the court found sufficient evidence to support.

In this case, the Storeks and other parties formed several limited partnerships known as "Old Oakland," the purpose of which was to redevelop a portion of downtown Oakland, restoring and converting several Victorian buildings into commercial space.

As the result of a complex series of financing transactions, which included sale of industrial development bonds by the City of Oakland, backed by letters of credit from Citibank, the bank obtained deeds of trust against plaintiff's properties, including junior liens against two unrelated properties located in San Francisco. A receiver was appointed and a foreclosure commenced by another lender holding a deed of trust against one of the San Francisco properties, constituting a default by Old Oakland under its agreements with Citibank. Following the later appointment of a receiver for Old Oakland, it also filed bankruptcy. Stay relief was granted to Citibank to foreclose its deed of trust, following which its affiliate purchased the property and invested additional funds to complete the project.

This lawsuit was commenced by the Old Oakland bankruptcy trustee, but rights to the claims asserted in it were sold to a group of the Old Oakland investors, including plaintiff Storek, who were substituted in as plaintiffs.

Plaintiffs alleged that Citicorp's decision that the project budget was out of balance, which the bank alleged was a breach of the agreement by Old Oakland, constituted a breach of the implied covenant of good faith and fair dealing, applicable to the parties' financing agreements. The jury at the trial level agreed, finding for plaintiffs against the bank in the amount of the undisbursed loan proceeds of $900,000. A substantial punitive damage award was included, and all of the parties appealed.

The Court of Appeal reversed, holding that as a matter of law, there could be no breach of the implied covenant of good faith and fair dealing when the conduct of which plaintiffs complained was expressly authorized by the terms of the loan agreements.

Most important was the Court's conclusion that the decision of Citicorp need only be <u>reasonable</u> from an objective standpoint. However, the Court found that the bank had no duty to exercise <u>good faith</u> in making a subjective determination as to whether the project budget was in balance, the satisfaction of which was deemed to be an express condition precedent to its obligations to make additional loan disbursements. Thus, the concept of objective reasonableness is separated from the standard of subjective good faith.

The court reviewed the holding of <u>Third Story Music, Inc. v. Waits</u>, 41 Cal. App. 4th 798, 48 C.R. 2nd 747 (1995). In that case, it was held that Warner Communications had no duty to act in good faith in exercise of discretion expressly granted in its contract , "to manufacture, sell, distribute, and advertise" the work of musician Tom Waits, or as further provided in its agreement, its further discretion to refrain from doing such things. When Warner failed to market Waits' music, it was held to be within its rights as provided under the contract. The court noted that the lesson of this case was that generally speaking, courts may not imply a covenant that is inconsistent wit the express language of a contract.

Applied to this case, the Court went so far as to state that no examination of the bank's exercise of its judgment could properly be made, as such good faith exercise was not required. The only claim that could succeed against the bank would be a claim of non performance of the express terms of the contract, which could show that its decision was not reasonable. But because plaintiff's claims no longer include breach of contract, they were not before the appellate court. Instead, the bank need only make an objectively <u>reasonable</u> determination that the project budget was in balance, of which facts the court found sufficient evidence to support.

<u>Crow Irvine #2 v. Winthrop California Investors Limited Partnership</u>, 104 Cal. App. 4th 996, 128 C.R. 2d 644 (2002).

Issues similar to those presented in the Storek case, discussed above, were again addressed in this case involving termination of a real estate development limited partnership by its limited partner. Defendant Winthrop California Investors Limited Partnership (Winthrop) invoked a provision of its partnership agreement permitting it to terminate based upon its "good faith" belief that differences between the partners would prevent them from achieving the expressed purpose of the partnership, which purpose was to develop a large tract of commercial property.

The trial court agreed with Plaintiffs argument that Winthrop's good faith belief that the partnership purposes could not be realized must be measured by an objective standard. The argument was made that a reasonable partner would have to agree that the decision was proper. The trial court seemed to believe that since the partnership was still in business, it was, in fact, accomplishing its purposes. This finding was made despite the fact that the parties had already sued one another on seven separate occasions, including a suit in Delaware by Winthrop to obtain access to partnership records.

The Court of Appeal reversed and remanded the case. It noted that the <u>Storek</u> case (analyzed above), cited by Plaintiff Crow Irvine #2(Crow), did not support Crow's position. Following the analysis of the <u>Storek</u> court, it noted that the partnership agreement in this case included a standard requiring exercise of good faith governing a partner's decision to terminate the partnership. Since the contract specifies the standard as requiring exercise of good faith, whether a partner's "good faith" belief that the partnership purposed are not being realized is actually a subjective test. Accordingly, exercise of the partner's judgment as to whether the partnership objectives are being realized need not be objectively reasonable - it needs only to be based upon its good faith belief.

The Court seemed to agree with Winthrop that the numerous lawsuits between the parties were sufficient to demonstrate that its decision that the partnership purposes were not being realized was the result of its good faith belief, noting that,

> Trust and confidence is the essence of a partnership relationship. If that trust and confidence is lost, it would be surprising if the partnership did not suffer.

<u>Crow Irvine #2 v. Winthrop</u>, supra, at p. 24.

The fact that the partnership managed to do something with the property was not, in this court's opinion, enough to show it was achieving its purposes.

CONCLUSION

We can expect to see more partnership litigation during the coming year, due to the dissolution of many law firms which conducted business as partnership entities. The fact that individual partners are often highly compensated individuals will provide lenders, landlords and other creditors with incentive to pursue individual partnership liability claims, such as that which occurred in the Annod case discussed above.

Whether partnerships and partners properly invoke termination causes will likely be the subject of future litigation, given the high stakes and dollars involved in law firm, real estate development and other partnership dissolutions, such as that discussed above in the Crow Irvine #2 case.

Continued improvements in the laws applicable to partnerships and limited liability companies can be anticipated, as business practitioners continue to pursue statutory changes that will benefit the consumers of California business entities. The Partnerships and LLCs Committee of the Business Law Section welcomes communications from practitioners bringing practice issues and problems encountered in these areas to its attention.

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